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SUBJECT: TREASURY UNDER SECRETARY ADAMS STUDIES ESTONIAN ECONOMIC REFORM MODEL

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¶1. (U) Summary: In a June 12 visit to Estonia, Treasury Under Secretary for International Affairs Timothy Adams met with Finance Minister Aivar Soerd, Central Bank Governor Andres Lipstok and representatives of the American Chamber of Commerce. He also hosted a roundtable discussion with leading reformers who managed Estonia's successful post-Soviet economic transition. Adams' trip focused on lessons the successful Estonian economic reform model might offer for other economies in transition, but it also provided an opportunity to hear about the challenges the Estonian economy faces moving forward. End Summary.

U.S. Business Community on Success and Challenges
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¶2. (SBU) In a meeting with the Estonian AmCham participating companies gave a broad overview of the Estonian tax system, which, with its flat tax and zero corporate tax rate on reinvested profits, is simple and competitive. The companies also pointed to technological innovation as a reason for Estonia's rapid economic transformation. They described Estonian usage of e-banking, electronic signatures, and e-voting as examples of ways Estonia is well ahead of other western states in terms of technology usage.

¶3. (SBU) The companies cited the amount of time and money it takes to register a business and a cumbersome notarial system as areas where improvement is needed. The companies agreed that the biggest challenge facing the Estonian economy in the future is labor. A representative of the North Carolina-based veneer company Baltispoon noted that the labor shortage is causing the company to rethink its plans for expansion in Estonia. Estonian Railways CEO Chris Aadnesen said that his company had to increase wages for its train operators 70 percent in a three month period. The companies agreed that the GOE needed to do more to simplify immigration and foreign work permit procedures in order to keep Estonia competitive. They also expressed concern about uncertainly over future Estonian tax policy, as EU requirements demand that Estonia give up its present corporate tax structure by January 2008.

Minister of Finance Notes Record Growth
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¶4. (SBU) Minister of Finance Aivar Soerd told U/S Adams that the Estonian economy is seeing record growth. The first quarter of 2006 showed 11.6 percent real GDP growth, with unemployment at seven percent and falling.

Soerd noted that Estonian public sector debt is the lowest in the EU at 4.8 percent of GDP, and mentioned that Estonia ran a budget surplus last year of 1.6 percent of GDP. Soerd said the government had just approved a comprehensive budget strategy through 2010, and confirmed that Estonia's new target for entering the euro zone is January 1, 2008. Adams welcomed the Minister's statement that Estonia planned to gradually graduate from the EBRD. Adams also raised a tax issue faced by the USAID-funded Baltic American Enterprise Fund.

Central Bank: Estonia Victim of its Own Success
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¶5. (SBU) At the Central Bank Governor Andres Lipstok reviewed Estonia's economic reform process, focusing on the creation of the currency board. Turning to the present, the delegation discussed the integration of the Nordic-Baltic banking market and the effect membership in the euro would have on Estonia. In conversation on the delay in Estonia's planned adoption of the euro due to higher-than-expected inflation, Lipstok lamented that Estonia was becoming a victim of its own success. He called the EU's euro accession criteria "excessively legalistic." Adams closed the meeting with an update on G-8 preparations and focused on the impact of rising energy prices on the world economy.

Reform Roundtable
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¶6. (SBU) A roundtable on Estonian reform at the Embassy brought together officials who shaped the Estonian reform policy and experience in the 1990s. Participants included Vaino Sarnet, former head of the Estonian privatization agency; Ain Aaviksoo, chairman of Estonia's leading social policy think tank Praxis; Hardo Pajula, a

former economic advisor to Estonian Prime Ministers; and Allan Martinson, a leading entrepreneur and venture capitalist. All representatives agreed on three keys to Estonian reform success. First, Estonia kept administrative reforms simple. It introduced a flat tax and zero tariffs, for example, because these would be easy to understand and administer. Second, Estonian reformers offered sufficient incentives to convince Estonians to endure tough reforms. At the beginning of the reform process, the GOE quickly restituted apartments, homes, and land, while at the same time administering the less popular, rapid privatization of industry.

¶7. (SBU) The third key to Estonian reform success was strategic management, or knowing what the state was not capable of managing effectively. Estonia's reform governments recognized they lacked broad economic experience, so they created a currency board arrangement to take monetary policy out of the hands of the government. For the same reason they adopted a simple, virtually unregulated, liberal trade policy, and put a balanced budget provision in the constitution. All of these efforts built confidence in Estonia's economic policies and encouraged increased trade and foreign direct investment, allowing the Estonian economy to expand at a rapid rate.

¶8. (U) Following the reform roundtable U/S Adams held a press conference which resulted in positive media coverage in Estonian print and television media outlets.

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